

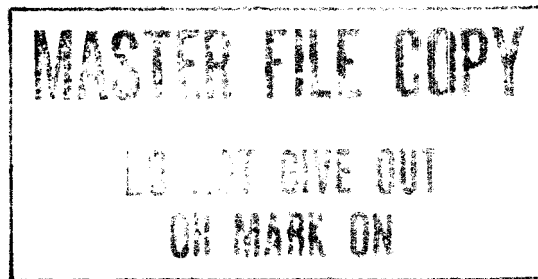


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Iran: Economic Recovery Prospects

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An Intelligence Memorandum



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**Directorate of
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Iran: Economic Recovery Prospects (U)

An Intelligence Memorandum

This paper has been prepared by [] Office
of Near East-South Asia Analysis. Comments and
queries are welcome and may be addressed to the
Chief, Persian Gulf Division, NESAC []

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This paper has been coordinated with the
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**Iran: Economic Recovery
Prospects**

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Summary

Having consolidated political power, the clerical regime in Iran has begun to give more attention to revitalizing an economy battered by three years of revolution and war. Tehran probably will initially pursue two broad economic policies designed to further the clerics' goal of establishing a more egalitarian "Islamic" society. The most important will be to direct substantial investment into social development programs to improve living conditions for the lower classes—the bedrock of regime political support. The second—economic self-sufficiency—will be emphasized to lessen dependence on foreign suppliers. If, as a result of a settlement with Iraq, Iran receives a reparations windfall, the regime will be tempted to quicken the pace of reconstruction.

The Khomeini regime's ability to develop an economic system consistent with its political philosophy will face many challenges, such as opposition from more conservative clerics and the likelihood of rising consumer expectations as revolutionary fervor ebbs. Moreover, practical considerations, including shortages of skilled technicians and managers, and the limitations imposed by Iran's resource base will influence the course of economic development, possibly more than the clerics' ideological preferences.

The rate and extent of economic recovery will be determined to a large degree by whether the clerics allow technocrats and other Western-trained specialists to resume effective control of the economy. There are indications that many within the regime recognize the importance of more effective economic management. We doubt, however, that the clerics will be willing in the near future to abandon their cherished aspirations of establishing a socially leveled and tightly controlled "Islamified" Iran. Consequently, even if technocrats are increasingly brought into managing the economy, ideological considerations will continue to heavily influence economic policy. Growth, as a result, will probably suffer.

Petroleum sales will continue to provide Tehran with almost all of its hard currency regardless of economic policy. The recent escalation of fighting between Iran and Iraq has had negligible impact on Iranian oil exports. Reconstruction, even at moderate levels, will require oil exports of at least 2.5 million barrels per day during the next several years. Iran will be forced to pursue aggressive marketing and price discounting to maintain export

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levels if world demand for oil remains sluggish. Iranian efforts to boost exports in the face of slackened world demand will also continue to undermine OPEC's ability to enforce production quotas and thereby maintain crude oil prices at the current \$34 per barrel.

Despite the regime's efforts to diversify its trading relationships, the Communist states are not likely to displace the developed Western countries as Iran's primary trading partners. Tehran currently obtains over two-thirds of its imports from the West—including most of its food and sophisticated technology. Economic reconstruction will push the share of Western trade with Iran even higher as Tehran, out of necessity and preference, leans to the West. These expanding economic relationships will, however, gain the West little new influence over the Khomeini regime.

The clerics' goal of improving economic conditions within Iran will not divert their attention from attempting to export the Islamic revolution in the Persian Gulf area. Instead, the regime will probably attempt to pursue economic reconstruction at home while encouraging ideological and military tensions in the Gulf region. Such a policy would dovetail with the clerics' desire to divert public attention from potentially divisive internal social and economic issues. Alleged foreign interference and threats against the Islamic Republic will continue to serve as convenient justifications for explaining economic failures at home.

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*Information available as of 25 July 1982
has been used in the preparation of this report.*

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**Iran: Economic Recovery
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The Shah's Legacy

Shah Mohammad Reza used Iran's oil revenues to launch a massive industrialization program and military buildup. Economic investment was concentrated in the metallurgical and petrochemical industries as well as development of basic infrastructure—transportation, communications, and utilities. Bottlenecks caused by transportation deficiencies, shortages of labor, and bureaucratic inefficiency, however, led to increasing delays, spiraling costs, and an annual inflation rate rising to 23 percent in 1976.

The Shah, sensing the depth of these economic problems, began in 1977 to scale back industrial programs in favor of basic infrastructure development. The last years of the Pahlavi era saw increasing emphasis on affordable growth. Industry was encouraged to use local materials and labor and to concentrate on producing intermediate goods—components and semifinished products—that were competitive in the world market.

The Shah's bias toward industrial development left the agricultural sector in a state of neglect. Because of underinvestment, agriculture remained largely traditional, employing about 40 percent of the labor force but providing only 9 percent of gross domestic product (GDP). Because domestic food production could not keep pace with demand, agricultural imports soared from \$70 million in 1970 to \$1.5 billion in 1978. Inadequate food production also contributed to the rapid inflation rate.

On balance, the Shah's economic policies did little to distribute the benefits of Iran's oil wealth throughout the population. Neglect of the agricultural sector contributed to a heavy rural migration to urban areas, exacerbating overcrowding and discontent among the urban poor. Similarly, the Shah's apparent lack of concern for the traditional middle class, mostly small-scale artisans, retailers, and manufacturers, drove many of them into the anti-Shah camp.

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**The Economy
Under Khomeini**

The Khomeini regime's preoccupation, until recently, with establishing effective political control and waging war against Iraq resulted in only haphazard attention to the economy. The only apparent goals during this period were to provide a minimum of essential goods and services to the population and to ensure adequate supplies for prosecuting the war. Efforts by some individuals, including former President Bani-Sadr and former Governor of the Central Bank Nobari, to increase oil sales by lowering prices and to curb excessive monetary growth became entangled in the political power struggle and contributed to their political demise.

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A butcher accused of profiteering is punished by the lashing of his feet by the Revolutionary Guards. [redacted]

Wide World ©

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By late 1981, however, with oil earnings plummeting (from \$1.3 billion in March to \$550 million by October) and foreign exchange reserves substantially reduced, the regime belatedly began to focus on its economic problems. Iranian light crude, overpriced at \$36.50 per barrel, was adjusted downward to the OPEC benchmark of \$34 per barrel. Drastic and effective restrictions were imposed on foreign trade, curtailing imports of all but the most essential foodstuffs, spare parts, and weapons. The luxury consumer goods trade through Dubai, for example, collapsed quickly following imposition of the trade quotas. Continuing slack demand for Iranian oil led in early 1982 to further price cuts and discounts, pushing down the average price of Tehran's crude to \$28 per barrel. [redacted]

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The regime's shift on oil pricing achieved significant results, and exports are now averaging over 2 million barrels per day (b/d), compared to 500,000 to 600,000 b/d in October 1981 [redacted] The decline in foreign exchange reserves, to below \$3 billion, has been halted, and present monthly oil earnings of roughly \$1.8 billion are sufficient to allow easing of strict import restrictions.¹ According to the US Embassy in

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¹ Earnings include a substantial barter element that represents the value of goods received in exchange for Iranian crude oil. [redacted]

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Table 1

Thousand b/d

Iran: Oil Exports

	1978	1979	1980	1981 ^a
Crude	4,522.4	2,407.0	874.0	830
Developed West	3,848.9	1,894.9	719.1	573
Eastern Europe	148.0	63.7	87.0	65
USSR	0	0	0	40
Developing World	525.5	448.4	67.9	152
Refined products ^b	127.5	172.6	226.0	
Total	4,649.9	2,579.6	1,100.0	830

^a Crude/refined product breakdown is not available.^b Exports by destination are not available.

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the United Arab Emirates, Iran has eased somewhat its trade restrictions with Dubai, a conduit for goods that had been closed last fall. We also have observed, by monitoring commercial activities, a flurry of buying activity by Iranian purchasing agents in West European and other markets. [redacted]

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Nevertheless, overall economic activity is severely depressed compared with the prerevolution period, despite the recovery in oil earnings. GDP has contracted in each year since the revolution and based on our projections is now probably only about half the 1977-78 level of \$74 billion. According to a number of estimates [redacted] industrial output, suffering from both shortages of material and skilled labor, is also stuck at less than half its prerevolution level. Nationalization of most industries and the imposition of "Islamic" political/ideological committees on the day-to-day running of plants also has contributed to flagging productivity. In recent months, shortages of industrial materials have, according to observers in Iran, forced the virtual closing of many plants and idling of additional workers. Based on our projections, over 30 percent of the adult work force is unemployed with an equal amount employed only marginally. [redacted]

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The agricultural sector, while not as hard hit as industry, also is depressed, and food production is stagnant. Chronic shortages of fuel, fertilizer, seed, and spare parts have, according to informed agricultural experts, adversely affected food output. The government's efforts to maintain low food prices

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for the urban population as well as considerable confusion over land reform plans have, we believe, provided little incentive for farmers to produce or invest in new equipment. Consequently, the exodus to urban centers continues undiminished. [] 25X1

Inflationary pressures continue to increase. Based on price observations [] we estimate the 25X1 current rate of inflation to be 70 percent or more. Large government deficits have been financed principally by printing more money. The 1982-83 budget, which has been published, includes a \$2 billion deficit, roughly 20 percent of projected spending. Over the past two years, the government has granted wage increases of 200 percent or more for many urban 25X1 workers, while at the same time placing restrictions on most consumer goods. As a result, [] most food and consumer items are strictly rationed or can be obtained only on the black market at prices at least triple the government-approved level. []

The urban lower class has been somewhat insulated from those price increases by the distribution of free food and some consumer goods through local mosques. Visitors to Tehran within the past six months have indicated this welfare system has worked reasonably well in meeting the minimum needs of this segment of the population, as well as providing the clerics with an effective instrument of political control. [] 25X1

Nevertheless, the clerical regime has repeatedly stated that the economic situation must be improved. The willingness of the population to endure present levels of unemployment, inflation, and scarcity of goods, even among the lower classes, we believe is probably linked to its emotional support of the revolution and the war against Iraq. Revolutionary fervor, however, is historically difficult to sustain, particularly in the face of pervasive economic hardship. The regime's recognition of this may lie behind its increasing emphasis on economic matters in recent months, including trade initiatives and the creation of an economic mobilization headquarters. [] 25X1

Future Policy and Problems

The Khomeini government has yet to announce a detailed reconstruction program, although it has outlined at various times in parliamentary debates its policy objectives. A key goal is to commit more resources to improving living conditions for lower class Iranians, the regime's main base of support. Better housing has been highlighted by Tehran as a priority objective. Rural development, including land reform, infrastructure development, and improved technical assistance for farmers, also has been singled out by the regime, both to increase domestic food production and to help stem the migration of rural poor into the cities. []

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Customers wait for bottled gas as shortages continue in Iran. [REDACTED]

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In the industrial sector, Central Bank Director Nurbakhsh has stated that the regime will expand large-scale basic industries including steel, nonferrous metals, petrochemicals, and automobile manufacturing. Renewed construction at Soviet-sponsored heavy industrial projects including power generation, steel, and nonferrous metallurgy, as well as substantial new orders for heavy industrial equipment from West European firms confirms that such expansion already is beginning. [REDACTED]

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Tehran will encounter formidable obstacles in its efforts to rebuild the economy. With limited financial, human, and material resources at its disposal, the regime runs the danger of overextending itself and facing the same delays, shortages, and frustrations that plagued the Shah's economic program. Even if Iran receives a reparations windfall in the event of a settlement with Iraq, development efforts would still be hampered by shortages of skilled labor, inadequate transportation, and chronic administrative problems. Sharply accelerated economic activity also would require the return of substantial numbers of foreign technicians and workers—a development the clerical regime will certainly try to control. [REDACTED]

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Even limited economic reconstruction, however, faces many problems. The regime's emphasis on rural development, for example, rests partly on land reform initiatives that are bitterly opposed in parliamentary debates by

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powerful conservative clerics and major landowners. We judge Tehran also will find it extremely difficult and costly to provide effective price incentives for farmers while it continues to insist on low food prices for urban workers. []

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Even if the regime can afford to subsidize both farmers and the urban population, there is no guarantee that this would increase agricultural productivity. To be effective, a price support program must be administered by a well-trained bureaucracy, sensitive to price fluctuations and capable of effectively reaching the bulk of the farming population, a difficult task in an agricultural sector as primitive as Iran's. Without resolution of the land reform issue and corresponding improvements in rural infrastructure and technical assistance, price supports may succeed only in perpetuating the present level of inefficient production. []

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The regime's goal of industrial self-sufficiency will also face serious difficulties. Attempts to reach self-sufficiency in such basic industries as steel and automobiles are certain to lead to spiraling import requirements. The end result, based on past experience in Third World countries, will be high-cost, inefficient domestic industries, unable to compete in world markets and dependent on growing state subsidies to survive. []

The regime may be tempted to promote political and military tensions in the Persian Gulf area, hoping thereby to divert public attention from potentially divisive internal social and economic issues. We believe the need to remain vigilant in the face of external threats will also be used to justify a slower pace of development, particularly if the regime believes that more rapid growth would threaten political stability. []

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Trade Policy

Iran's foreign trade policy also reflects the clerical regime's attempts to restructure economic relationships. Tehran is expanding, and to some extent, diversifying trade in an effort to avoid dependence on any one nation or bloc. Trade agreements signed in recent months with Turkey, Syria, Pakistan, and Brazil suggest a deliberate effort to expand Third World commercial ties. Tehran's arrangement with Syria involves an exchange of Iranian crude for Syrian goods and a commitment by Damascus to close the Iraqi oil pipeline. This suggests a heavy political content to some of Iran's commercial relations. []

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Iran has renewed and in some cases expanded relations with Communist nations, despite continuing suspicion of Soviet intentions. Much of the growth in trade with the Communist countries was initially due to Western trade sanctions and to the fact that Communist countries were more

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Table 2

Million US \$

Iran: Trade With World

	1976	1977	1978	1979	1980	1981 ^a
Total trade	36,173	39,115	43,526	30,305	26,681	22,050
Imports	13,218	14,894	18,561	8,578	11,461	10,970
OECD	10,941	12,094	15,487	5,807	7,572	7,400
Non-OPEC LDCs	1,380	1,501	1,670	1,648	2,187	1,600
Other OPEC	127	224	287	372	460	400
USSR	290	577	636	416	399	380
Eastern Europe ^b	480	498	481	335	843	1,190
Exports	22,955	24,221	24,965	21,727	15,220	11,080
OECD	18,365	18,986	18,915	15,204	10,217	6,900
Non-OPEC LDCs	3,695	4,202	5,044	5,608	3,673	2,600
Other OPEC	123	118	106	127	96	80
USSR	302	385	350	210	116	630
Eastern Europe ^b	470	530	550	578	1,118	870

^a Estimated.^b Excluding data for East Germany.

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receptive to barter trade with a cash-short Iran. Trade with the Soviet Union, according to Soviet published data, has rebounded to prerevolution levels. Iranian media reports state that work has resumed on many joint Soviet-Iranian industrial projects that had been suspended or slowed in the past three years. Imports of industrial raw materials, machinery, and equipment from the USSR, as well as the number of Soviet technical advisers probably will grow as work progresses on these projects.² The Communist countries also are major arms suppliers; close to two-thirds of the approximately \$1.2 billion in arms agreements that Iran was known to have signed in 1981 were with Communist countries, about half with North Korea alone.

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The Communist nations' desire to boost trade with Iran, however, will be checked by their inability to meet Iran's heavy requirements for foodstuffs, most sophisticated industrial equipment, and petroleum technology. All are

² We believe that 2,500 to 3,000 Soviet technicians and advisers are working on 55 economic and technical projects in Iran. Moscow will seek an expanded presence to increase its influence in Iran, but its demands for payment in hard currency will continue to hold down aid levels in the near term and limit the number of advisers to the prerevolution level of about 4,500. The types of Soviet technical and economic assistance are virtually unchanged from that provided under the Shah.

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food deficit countries and cannot produce the range and quality of goods and services available from the West. Tehran, out of necessity and preference, will depend on the West. There are signs that Tehran is increasingly turning to developed Western countries to meet its import requirements:

- Talbot, the British automaker, has signed an agreement with Iran to deliver an estimated \$360 million worth of unassembled autos over the next two years.
- Krupp, the West German firm, has reported industrial orders worth \$94.8 million in 1982, more than double last year's \$37.6 million sales to Iran.
- Tokyo and Tehran are [] nearing agreement on resuming work at the \$4 billion petrochemical complex at Bandar Khomeini. 25X1
- Kraftwerk Union, a West German company, has begun shipping \$850 million of equipment for the Bushehr nuclear reactor.
- Tehran has approached West German oil companies to explore the possibility of increasing oil sales in exchange for cooperation in rebuilding Iran's oil industry. [] 25X1

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The Western share of Iranian trade probably will continue to grow as Tehran begins reconstruction in earnest. West Germany, Italy, and Japan will probably reap a substantial share of new contracts because they are major buyers of Iranian crude and long preferred trading partners. []

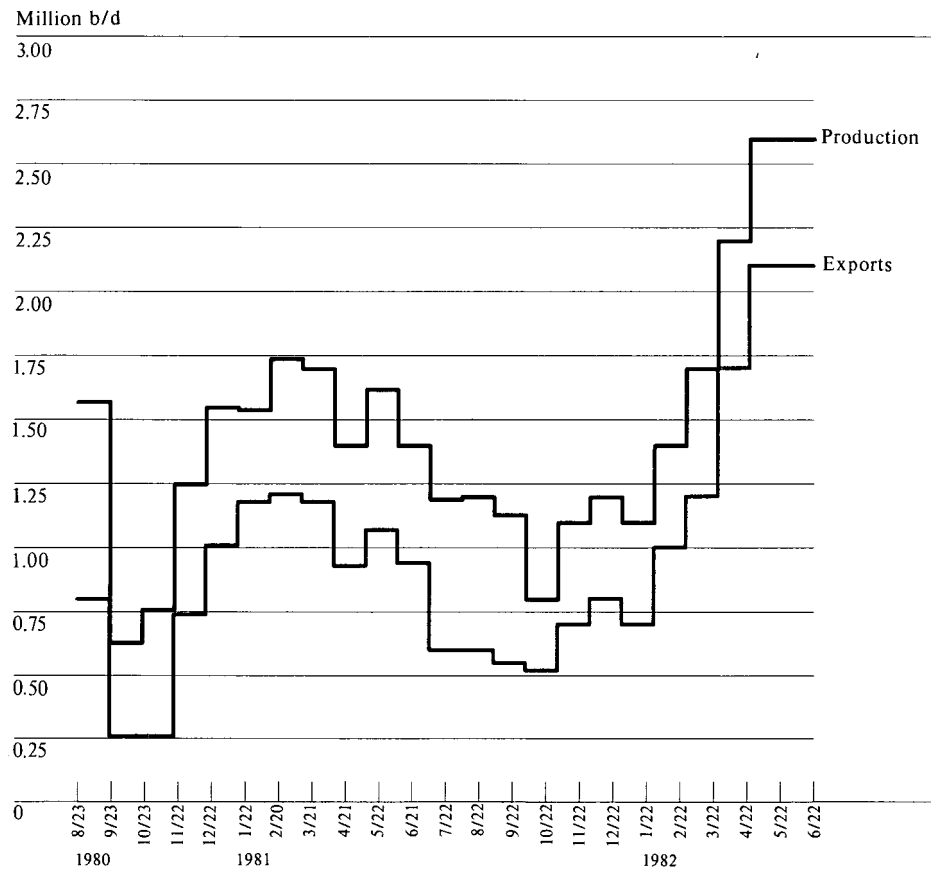
The regime's strong bias against the United States will probably limit direct US trade contacts, although sales of grain and other goods through European middlemen are likely to be brisk over the next several years. In such critical areas as petroleum technology, the Iranians may deal directly with US firms. We do not expect, however, a significant change in Tehran's anti-US stance. [] 25X1

Petroleum Export Policy

The recent escalation of fighting between Iran and Iraq has had negligible impact on Iranian oil exports. Liftings from Khark Island, Iran's primary export terminal, dipped momentarily in mid-July to 1.8 million b/d from the 2.3-million b/d average of the previous month, following Iraqi air attacks and cancellation of some tanker liftings by Western and Japanese firms. The combination of higher tanker charter rates and the poor financial condition of the tanker shipping industry has, however, resulted in the majority of tanker owners ignoring potential hazards and readily offering their vessels for liftings at Khark. We anticipate, accordingly, that the Iranians will continue to have little difficulty in moving crude oil out of Khark despite sporadic attacks by the Iraqis. [] 25X1

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Iran: Crude Oil Production and Exports

^aIncluding product exports. Data are an average for period.

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Iran will depend on oil revenues for the overwhelming majority of its export earnings, and economic reconstruction will probably force Tehran to boost production. Large war reparations payments, which Tehran has demanded from Baghdad would, on the other hand, lessen its need for higher production levels. Oil earnings also would be enhanced by an end to hostilities with Iraq, enabling Tehran to reduce the substantial price discounts of \$3 or more per barrel it must offer to offset war risk insurance and buyer apprehension. [REDACTED]

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In lieu of large war reparations, Iran will look for ways to boost exports. Economic reconstruction, even at modest levels, will probably require exports of at least 2.5-3 million b/d. Recently, the Iranian Petroleum Minister publicly stated that Iran will seek to export at the 2.5-million b/d level. []

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We estimate, [] that Iran would not be able to export much beyond 3 million b/d in 1982 without substantial well workover and drilling programs to make up for inadequate maintenance over the past three years. Such an effort could probably be substantially completed within one year with foreign help and Iranian oil-production capacity restored to 4-5 million b/d. []

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Iranian efforts to boost exports in the face of slackened world demand will continue to undermine OPEC's ability to enforce production quotas and thereby maintain crude oil prices at the current \$34 per barrel level. The Iranian regime is likely to continue to ignore both OPEC production quotas and pricing policies. The Prime Minister recently charged that both are controlled by Saudi Arabia, which continues to saturate the world oil market to further US interests and to "confront Iran's Islamic Revolution" by trying to prevent Iran's export of oil. []

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Key Future Economic Indicators

The speed and extent of economic recovery may turn on whether the clerics will allow technocrats and other Western-trained specialists to resume effective control of the economy. Conversely, the longer the clerics impose "Islamic" solutions to economic problems, including nationalization of foreign trade, interference in plant management, and excessive political control of the economic sector, the more likely that growth will be stymied. []

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We doubt that the clerics will be willing in the near future to abandon their cherished goal of establishing a socially leveled and tightly controlled "Islamified" Iran. We suspect that clerical interference, particularly in domestic economic matters, will continue. Growth, as a result, will probably suffer. []

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[] Clerical leaders, moreover, continue to emphasize the need for trained technical personnel to manage economic affairs. These developments do not suggest, however, that the regime has adopted a more flexible approach to the economy. []

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Tehran may ultimately find a sharply reduced version of the Shah's economic program to be the most practical course. Such a strategy, emphasizing expansion of export-oriented intermediate goods industries that are intensive energy users, such as petrochemicals and nonferrous metallurgy, would probably be cost effective. In agriculture the introduction of large-scale commercial farming in selected areas probably would promote progress in reducing the food deficit. Adoption of such economic policies, however, will require a degree of economic pragmatism not yet shown by the regime.

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